

ANALYSIS OF ORIGINAL BILL

Author: Cedillo Analyst: Garnier Bill Number: AB 2257
Related Bills: None Telephone: 845-5322 Introduced Date: 2-19-98

Attorney: Doug Bramhall Sponsor:

SUBJECT: Exempt Health Care Service Plans - Required Disclosure and Excess Benefits Transaction Tax

SUMMARY

This bill would require tax-exempt organizations that are "health care service plans" (HCSP) with subsidiary for-profit companies to disclose and make available to the public for copying specified transactions, employee compensation, reports and ownership interest in the subsidiaries. Additionally, this bill would provide that the federal provisions relating to additional taxes on "excess benefit transactions" apply to HCSPs.

EFFECTIVE DATE

This bill would be effective for income years beginning on or after January 1, 1999.

SPECIFIC FINDINGS

Under **federal law**, tax-exempt organizations may not engage in any activities that result in private inurement to persons that may exercise influence over the organization. Prior to 1996, the only recourse the Internal Revenue Service had against organizations engaged in such activities was the revocation of the organization's tax-exempt status. The Taxpayers Bill of Rights 2 (TBR2) (P.L. 104-168) provided for new intermediate sanctions for organizations engaged in private inurement-type activities. The TBR2 also increased the disclosure requirements for certain tax-exempt organizations.

The intermediate sanctions or penalty excise taxes are imposed for "excess benefit transactions" entered into by the "applicable tax-exempt organization" with "disqualified persons" and/or "organization managers."

The applicable tax-exempt organizations are:

- Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or

DEPARTMENTS THAT MAY BE AFFECTED:

___ STATE MANDATE

___ GOVERNOR'S APPOINTMENT

Board Position:

___ S ___ O
___ SA ___ OUA
___ N ___ NP
___ NA ___ NAR
___ X ___ PENDING

Agency Secretary Position:

___ S ___ O
___ SA ___ OUA
___ N ___ NP
___ NA ___ NAR
DEFER TO ___

GOVERNOR'S OFFICE USE

Position Approved ___
Position Disapproved ___
Position Noted ___

Department Director Date
Gerald H. Goldberg 4/7/98

Agency Secretary Date

By: Date

international amateur sports competition, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the organization is to influence legislation, and which does not participate in, or intervene in any political campaign on behalf of (or in opposition to) any candidate for public office.

- Civic leagues or organizations not organized for profit but operated exclusively for the promotion of social welfare, or local associations of employees, the membership of which is limited to the employees of a designated person or persons in a particular municipality, and the net earnings of which are devoted exclusively to charitable, educational, or recreational purposes.
- Any former tax-exempt organization which was described above at any time during the five-year period ending on the date of the excess benefits transaction.

Excess benefits transactions are transactions in which the exempt organization provides a benefit, directly or indirectly, in excess of consideration received by the exempt organization to a disqualified person. Statutory and related case law existing prior to the enactment of the TBR2 applies in determining the reasonableness of compensation and fair market value.

Disqualified persons are defined as:

- Any person who was, at any time during the five-year period ending on the date of the transaction, in a position to exercise substantial influence over the affairs of the exempt organization.
- Any family member of an individual described above.
- A 35% controlled entity. In determining whether an entity will be treated as a controlled entity, certain constructive ownership rules apply.

Organization manager means any officer, director, or trustee of the organization, or any person having powers similar to an officer, director or trustee of the organization.

A tax equal to 25% of the excess benefit (first-tier tax) is assessed on the disqualified person receiving the excess benefit from the organization. Additionally, a tax equal to 10% of the excess benefit is assessed on all organization managers who know that the transaction entered into by the organization and disqualified person is an excess benefit transaction. The tax on the organization manager will not be assessed if the organization manager's participation was not willful and was due to reasonable cause.

If the organization and the disqualified person do not "correct" the excess benefit within the "taxable period," a second-tier tax of 200% of the excess benefit amount is also imposed on the disqualified person. Correct or correction means undoing the excess benefit transaction or restoring the financial position of the organization had the disqualified person acted with the highest fiduciary standards (the excess benefit amount has to be returned to the organization in one manner or another). Taxable period means the period beginning with the date the excess benefit transaction occurred and ending with the earlier of the date

of the mailing of the notice of deficiency for the first tier tax or the date of assessment of the first tier tax.

The first-tier tax may be abated if the taxable event was due to reasonable cause and not willful neglect and the taxable event was corrected within the "correction period." Second-tier taxes are also abated if the excess benefit transaction is corrected during the "correction period." The correction period is defined in the applicable Internal Revenue Code Treasury regulations to mean that period beginning with the date of the taxable event and ending 90 days after the date of the mailing of the notice of deficiency for taxable event. The correction period may be extended under certain circumstances.

The TBR2 also requires organizations discussed above to disclose on their information returns all taxes paid by the organization or disqualified person due to excess benefit transactions and other such information the Secretary of the Treasury may promulgate in regulations. Ninety days after the publication of final regulations, organizations will be required to make available for public inspection at most of its regular offices the application for exemption and other supporting documents. Current law requires only the information return be made available for public inspection. The TBR2 provides that organizations may charge a reasonable fee for copying the information. The application for exemption and other supporting documents are presently available for public inspection at federal Freedom of Information Reading Rooms. The TBR2 also requires that 90 days after publication of final regulations, the organization must respond within 30 days to written requests for information. Relief is provided for organizations which are determined to be a target of a harassment campaign. The Secretary of the Treasury promulgated proposed regulations on September 26, 1997.

The TBR2 also increased the penalty for organizations not complying with filing and disclosure requirements. The penalty was increased from \$10 per day for each day of non-compliance, with a \$5,000 maximum, to \$20 per day, with a \$10,000 maximum.

California law has not conformed to any of the TBR2 provisions discussed above. Generally, California law contains rules similar to the provisions of the Internal Revenue Code as of January 1, 1997, relating to filing requirements and penalties, disclosure, and private inurement for tax-exempt organizations discussed above. California's penalty for a tax-exempt organization's failure to file a complete information return is \$50 per occurrence, as opposed to the current \$20 per day federal penalty.

This bill would provide that the excess benefit taxes described above apply to any tax-exempt HCSP, defined in the Health and Safety Code as:

"any person who undertakes to arrange for the provision of health care services to subscribers or enrollees, or to pay for or to reimburse any part of the cost for those services, in return for a prepaid or periodic charge paid by or on behalf of the subscribers or enrollees."

Generally, this includes all tax-exempt health maintenance organizations (HMOs) (beginning in the early 1990s most of the HMOs converted to "for-profit" status). This bill would also conform to the federal penalty tax percentages of 25% on

disqualified persons, 10% on organization managers and 200% on excess benefits transactions not corrected within the taxable period.

This bill would also require tax-exempt HCSPs to disclose:

- Transfers of money and loans made to any subsidiary for-profit corporation.
- Compensation that employees receive from any subsidiary for-profit corporation.
- Ownership held by directors, officers, employees, or related family members in any subsidiary for-profit corporation.
- Annual reports of any subsidiary for-profit corporation.

This bill would provide that all tax-exempt HCSP are required to :

"make available to the public for copying at its facility all returns required under this article. In the case of a multifacility system, the returns of all the system's subsidiary exempt organizations shall be made available to the public for copying in the offices of the system's parent corporation and regional headquarters."

This bill would not (as provided under federal law):

- Apply to tax-exempt organizations other than HCSPs, as defined.
- Allow for excess benefit tax abatement for any reason (the tax would not be assessed on organization managers if the action causing the assessment is due to reasonable cause).
- Require any excess benefit tax paid to be disclosed on the tax-exempt HCSP's information return.
- Provide for disclosure requirement relief for organizations subject to a harassment campaign.
- Increase the penalty for failure to file a complete information return.

Policy Considerations

Conforming to federal tax law is generally desirable because it is less confusing for the taxpayer, particularly when dealing with complex areas such as the tax on excess benefit transactions. With conformity, the taxpayer will only be required to know one set of rules. Conformity also eases FTB's administration of the law by utilizing many federal forms and instructions. However, this bill would only partially conform to the tax on excess benefit transactions or the reporting and or disclosure requirements of certain tax-exempt organizations and would not conform to the first and second tier abatement provisions in federal law.

Generally, when California conforms to this type of excise tax or penalty, the excise tax or penalty rate is reduced to reflect California's lower than federal tax rates (e.g., excise tax on early withdraw from IRAs is 10% at the federal level and 2.5% at the state level; the excise tax on gross receipts for publicly traded partnerships is 3.5% for federal and 1% for state.) This bill would conform to the federal penalty excise tax rates without reducing the rates for California purposes.

This bill would require HCSPs to disclose certain confidential information regarding a for-profit subsidiary to the general public. Under present law, the department is prohibited from disclosing such information. This bill would not modify the department's general disclosure statute to permit disclosure of such information.

Implementation Considerations

The department has identified the following implementation concerns. Department staff is available to work with the author's office to resolve these and other concerns that may be identified.

In order for the department to effectively administer the provisions of this bill, the term "subsidiary" should be defined.

The bill states that the tax-exempt HCSP shall disclose specified information and shall make available to the public all returns required under Bank and Corporation Tax Law, Chapter 4, Article 1, of Part 11 of the Revenue and Taxation Code. The filing requirements for tax-exempts are contained in the Administration - Franchise Tax Board Law, Part 10.2 of the Revenue and Taxation Code. Additionally, the bill does not require the specified information to be part of an information return.

Technical Considerations

For federal purposes, if the excess benefit transaction is not corrected within the taxable period, the 200% second-tier tax is imposed. The taxable period means the period beginning with the date the excess benefit transaction occurred and ending with the earlier of the date of the mailing of the Notice of Deficiency for the first-tier tax or the date of assessment of the first-tier tax. This bill would conform to these federal provisions without modifications. California uses different terminology for deficiencies and/or assessments; therefore, it is unclear how the 200% second-tier tax may be assessed at the state level.

It is unclear if the tax-exempt HCSP would be allowed to charge a reasonable fee for copying the information required to be available for public viewing.

FISCAL IMPACT

Departmental Costs

Insignificant departmental costs would be incurred implementing the bill.

Tax Revenue Estimate

The revenue impact of this bill would be determined by the assessment of penalty excise taxes as an intermediate sanction when health care service plan (as defined) engages in an "excess benefits transaction."

Based on the very low level of federal estimates for this provision in H.R. 2337 (1996), conforming to IRC Sec. 4958 would result in minor revenue gains of less than \$500,000 annually beginning in 1998-99. The bill would be

effective with income years beginning on or after January 1, 1999, with enactment assumed after June 30, 1998.

BOARD POSITION

Pending.